



# Family Office Association

# Q&A

Angelo J. Robles on

## Family Wealth Evaporation Trap

w/George A. Isaac III

President, GAI Capital Ltd.

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## OVERVIEW

- Q: Are there any major family business issues that are not being adequately addressed by family offices today?
- Q: How can so many family offices overlook this critical family wealth management matter?
- Q: What are the problems with current family office practices?
- Q: How have families historically dealt with these issues?
- Q: What is a better alternative?
- Q: Based upon your experience, how big of an impact can the Family Wealth Roadmap™ process make?
- Q: What is the best way to implement the Family Wealth Roadmap™?
- Q: Are there any reasons why a family would not want to implement these ideas?



**AJR:** Are there any major family business issues that are not being adequately addressed by family offices today?

**AJR:** How can so many family offices overlook this critical family wealth management matter?

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**GAI:** Yes, one big one from my perspective! Many family offices are unknowingly taking on unrecognized risks with their family businesses resulting in lower family shareholder ROIs and less liquidity for the family.

The core problem is the misalignment of the family business asset with the overall family wealth portfolio. This misalignment results in family offices and families looking at the family business as an “operating entity” and only their other assets as “investments” Under this course of action, each asset class is managed separately with differing paradigms and objectives. The results are overall underperformance.

We of course recognize the other important family attributes that a family business provides; however, from a wealth management perspective, the family business should be looked at through an investor’s perspective and managed as part of a family’s overall portfolio of assets. When you make this change in perspective, a whole series of new decision making processes and financial disciplines come into play. We see our job as helping our clients understand the benefits from this major change in paradigms and recognizing the positive financial impact of partially realizing family business wealth creation as it is being created.

**GAI:** Let’s first recognize that family wealth typically comes from successfully running a family business. The skills necessary to successfully run a family business and create wealth are different than the skills of a professional investor to manage family wealth. So it is not surprising that many family business CEOs do not look at their family businesses as a concentrated investment asset class. In essence, the family business is kept off the table away from family office investment professionals.

Part of the reason is the many operational issues that consume management’s attention in running a family business. On top of that, the softer issues associated with family dynamics need to be skillfully managed. Issues such as governance, succession planning, family member employment, compensation and perks, and shareholder returns/distributions can impact family dynamics and in the end, overall business longevity and success. Therefore, it is not surprising that the issues associated with managing the business as an investment asset gets missed.



**AJR:** What are the problems with current family office practices?

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**GAI:** Research suggests that over 50% of family offices have a family business. This percentage varies by region and country so the first question is what percentage of the family wealth is associated with the family business. If the family business represents a significant percentage of overall family wealth, then one problem is the lack of family wealth diversification and the obvious associated risks of being concentrated in one industry/asset class.

Another problem is that the wealth created by a family business is literally “unrealized” stock appreciation gains until actual cash ends up in the shareholders’ pockets. Quite often, the majority of wealth created in the family business is not realized for decades. How many times have unrealized gains evaporated (e.g. the recent Great Recession)? The lack of partially harvesting family business wealth as it is being created becomes a major risk for the family’s overall long term wealth.

Specific issues include lower shareholder IRR’s and less liquidity. The less obvious risks are exposure to “tail-risks”, that is, the unforeseen and unpredictable risks that can destroy family business value over time. Examples include:

- Technical obsolescence of main product segment
- Loss of key executives, major customers or an attractive supply base
- New competition with a better mouse trap
- Product liability exposures or revised government regulations
- Catastrophic event with facilities/business interruption
- Family feuds/loss of senior family leadership/succession problems/disparate shareholder direction/objectives, etc.
- Other events we are not even aware of!



**AJR:** How have families historically dealt with these issues?

**AJR:** What is a better alternative?

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**GAI:** Some families sell their family business principally to generate liquidity and to diversify the family's investment holdings. Others bring in an equity partner and partially sell out to accomplish the same. Unfortunately, both of these approaches are costly since they trigger additional capital gain taxes resulting in less wealth to be reinvested into other asset classes. In addition, the family business ROI is typically the best performing ROI investment in a family's wealth portfolio. The result of a sales transaction is having less capital to reinvest in lower performing ROI assets. We have found less costly and more effective alternatives that even can eliminate the need to sell a family business solely for liquidity/diversification objectives.

**GAI:** A better alternative is a solution that we titled, *The Family Wealth Roadmap™*. The Roadmap evaluates the cash flow generation capabilities and capital needs of the family business and then designs the appropriate capital structure to meet both liquidity and diversification objectives for the family while protecting the current and future capital requirements of the business. This approach often results in a variety of non-equity based capital provided to the business. It is supported by creating one or more special purpose entities with specific financial strategies and shareholder agreements to mitigate any incremental risks. The Roadmap has three phases: Creating Wealth, Realizing Wealth, and Preserving Wealth.

**The Creating Wealth Phase** evaluates the operating business to assess the sustainability and volatility of cash flows and determine the future capital requirements for the family business. This requires an in-depth and objective evaluation of the business including understanding of markets, operating costs, systems, customer and product profitability, volatility of cash flows, and capital requirements to support the business. The primary objective of this phase is to protect the family business and its future value creation capabilities.

**The Realizing Wealth Phase** rationalizes both the working capital and fixed assets of the business to determine the appropriate assets and corresponding capital structure needed to support the growth of the business. Recommended reinvestment hurdle rates and new financial management disciplines are incorporated into the management of the business. Various shareholder distribution strategies are modeled to balance meeting shareholder ROI and liquidity needs with supporting the family business future needs. In addition, this phase designs and develops alternative financing options and an overall 3 to 5 year financial plan for the business and the shareholders. The output is an ability to distribute cash to shareholders.

**The Preserve Wealth Phase** finalizes the strategies and the capital structures and develops the shareholder operating agreements for the special purpose entities that will receive shareholder distributions. Part of the strategy is to protect family assets from creditors or litigators. A master investment plan is also developed to direct any liquidity generated from the family business into the appropriate investment vehicles. Issues associated with asset protection strategies, individual family member liquidity, call and put rights, portfolio volatility modeling, etc. are completed during this phase. In addition, all of the legal documents are developed and executed.





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**GAI:** That depends on the family business's proportionate size to the overall family's wealth. However, it is safe to state that the most critical post financial crisis objectives for family wealth management can be met such as:

- Improved risk management, particularly unforeseen tail risks
- Improved family liquidity
- Tailoring of investments to meet individual family member needs/objectives
- Optimized risk-adjusted portfolio IRR's for the entire family wealth portfolio
- Efficient and custom wealth transfer while maintaining family business control positions
- Increased family wealth asset protection

In a recent client case, the family business IRR went from 13% to 19% based upon implementing the Family Wealth Roadmap.

**GAI:** We recommend a multi-tiered project team approach composed of legal resources (estate and corporate counsel), investment team (family office with external advisors if they are used), insurance advisor, and a family office/business consultant. Overseeing the project by a project steering committee composed of the family office senior executives, individual family member advisors, the family business CEO and CFO is helpful so that both family and family business objectives are met.

**GAI:** From an objective perspective, I don't believe there are any sound reasons to not implement these recommendations, assuming they are not doing something similar already. For example, real estate companies often have similar shareholder distribution strategies due to their leveraged capital structure and ability to refinance on a tax-free basis. However, the unique difference with our approach is the use of special purpose entities to protect any enterprise that takes on additional risk through recapitalization. This would be beneficial for real estate companies as well.

From an emotional reason, some families simply do not want to take on debt. I ran our family business the same way back in the 1980's, before I knew better! However, after considering and carefully reviewing our Family Wealth Roadmap™, I believe any emotional reasons to avoid debt can easily be overcome, even with the most conservative family ownership groups through the structure and operating guidelines of the special purpose entities.

In addition, the benefits associated with making these changes are compelling. They can make a several percentage point increase in the family business shareholder IRR's in addition to improving liquidity and reducing risk. That is why I am so excited about working with clients on this issue.



Angelo J. Robles ▶

## FAMILY WEALTH EVAPORATION TRAP w/George A. Isaac III



**Angelo J. Robles** is the Founder and CEO of the Greenwich, Connecticut-based Family Office Association (FOA), a global membership organization that provides private educational and networking forums with top experts, plus thought leadership and proprietary research about and for multiple generations of wealthy families and the professionals who run their single family offices.

A member of the Princeton Council on Family Offices and the NYU Stern Family Office Council, Mr. Robles has a long track record of leadership positions at top financial service companies, including UBS. Before launching FOA, he engaged in several successful entrepreneurial ventures: He founded the New England chapter of the Hedge Fund Association (where he also served as president) and pioneered online retirement planning for Fortune 1000 executives with two Internet startups: 401KRollover.com and IRARollovers.com.

At FOA, Mr. Robles has spearheaded a series of provocative and groundbreaking Q&As with industry experts, and white papers that address the unique needs of ultra high net worth families in the U.S. and around the globe. These publications provide in-depth case studies of vibrant, multi-cultural single family offices as well as sophisticated approaches to wealth protection and growth, philanthropy, technology, social media, legal, tax, insurance and lifestyle concerns.

Mr. Robles has written several books and articles, and has appeared on Bloomberg Radio & TV and quoted in Thompson Reuters, Institutional Investor, Opalesque, Registered Rep, HFM Week, Investment News, EurekaHedge, The Luxury Institute, Private Asset Management, The Greenwich Times and many others.



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### *Family Office Association Q&A*

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**George Isaac** is the founder and Managing Principal of GEORGE ISAAC CONSULTING (a division of GAI Capital Ltd.), a specialized management consulting practice providing comprehensive services to family businesses and family offices. Mr. Isaac works with clients to create, realize and preserve family business wealth, relying on the perspective and skills gained through decades of experience across industry sectors. During his career, he has served at nearly every level of management within a family enterprise structure, from CEO and Corporate Board Member to a trusted external advisor.

Mr. Isaac has served on 14 public and private corporate boards for companies ranging in size from \$30M to \$1B and has consulted on over 100 client engagements in a variety of industries. As a result, he has a rare understanding of all aspects of starting and maintaining a family business, from the technical to the behavioral. His experiences as a Deloitte management consulting partner, senior executive/corporate board member, and a private equity investor provides him with the unique perspectives of an operating executive, management consultant, and investor to deliver pragmatic, strategic and implementable counsel to his family business/family office clients.

Mr. Isaac is also the co-managing member of the Isaac family office, GeoZac Holdings, Ltd.. In addition, he owns and operates a metals recycling company and serves as co-managing member of two of his family's 2nd generation operating companies, and on the board of directors of his 4th generation family real estate business, The Isaac Group. His prior investment experience includes participating in the formation of a fund of funds hedge fund and in actively investing in private equity and early stage transactions in addition to public security transactions.

Mr. Isaac is a frequent speaker at national and international business meetings and conferences and has had several articles published on family enterprise issues. He is a member of Young Presidents' Organization, the National Association of Corporate Directors and an International Board Member of Chief Executives Organization (CEO). Mr. Isaac is a Certified Management Consultant (1984) and has an MBA with distinction in Finance and a B.S. Industrial & Operations Engineering from The University of Michigan.



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